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College of Commerce and Business Administration
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The sales tax merry-go-round slowed briefly on June 23, 1975 to spin off the Government's Green Paper, entitled Discussion Paper--Federal Sales and Excise Taxation. Canada's earliest experiment with a sales tax, a turnover or cascade tax on the German pattern, in 1920 produced such strenuous opposition that it was replaced by the present manufacturers sales tax as of January 1, 1924—nearly 52 years ago. The levy was a pioneer for this type of sales tax--there were no others in existence. While this form was clearly preferable to the intolerable turnover tax, it was not a popular levy and might well have been phased out if its life had not been saved by the great depression of the Thirties. It was tolerated as a necessary evil over the depression and war years, but in the late Forties, complaints were heard again. In 1951 the Canadian Tax Foundation, then only five years old, published the volume I had prepared for it, The General Manufacturers Sales Tax in Canada. The tax was discussed in the annual Conferences of the Foundation over the next four years,[1] and the Foundation, in February of 1955, submitted to the Minister of Finance a memorandum suggesting the need for reconsideration of the structure and operation of the tax with respect to the definition of taxable price and the machinery and building materials exemptions, which had emerged as the most troublesome aspects. As a consequence of this submission and representation of other groups, the government established a Sales Tax

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1. Report of the Proceedings of the Fifth Tax Conference, 1951, pp. 55-68; Sixth, 1952, pp. 41-46; Seventh, 1953, pp. 45-47 and Data Paper, Sales Tax, pp. 1-33; Eighth, 1954, pp. 83-116.

Note also "Manufacturers Sales Tax", Tax Bulletin, Vol. 2 (Jan.-Feb. 1952), pp.1-32; A.M. Moore, "What is the Sale Price/", Canadian Tax Journal, Vol. 1 (July-August 1953), pp. 384-90.

Committee, headed by Kenneth Carter, to investigate various aspects of the tax and make recommendations for change. During the work of the Committee, the 1955 Tax Foundation Conference again saw substantial discussion of the issues.[1] The very brief and cryptic report, entitled Report of the Sales Tax Committee, was issued in January 1956, and served as the basis for discussion at the Tax Foundation's 1956 Conference in Montreal.[2]

In addition to specific recommendations relating to taxable price, appeals from the Minister's decisions, and other matters, the Report somewhat unexpectedly stated "At some future date after suitable preparation and explanation to taxpayers, the basis of the tax be changed from the manufacturers' level to the level at which retailers purchase goods."--p.16. Only a brief explanation of the merits of the change was given, but further elaboration was provided by Mr. Carter at the 1956 Foundation Conference. The reaction to the proposal was rather negative, centering around the feeling that the change would not accomplish much and that it might lead to new discrimination against various systems of distribution channels and complicate administration. As a consequence, the Minister of Finance announced in the 1957 budget message that this change would not be implemented (nor were the other changes proposed in the Committee report).[3] The arguments were basically the same as those currently employed.

Interest in the sales tax and in reform lessened somewhat for the next several years, but the question was discussed on a less frequent, roughly

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[1] Proceedings, op. cit., 1955, pp. 231-290.

[2] Proceedings, op. cit., 1956, pp. 139-166.

[3] J.F. Due, "Report of the Sales Tax Committee--One Year in Retrospect," Canadian Tax Journal, Vol. 5 (March-April, 1957), pp. 88-105.

biennial basis at the Tax Foundation conferences.[1] The tax continued to operate in much the same fashion, with some improvements in operation as personnel in National Revenue changed. There was a flurry of interest in a value added tax on several occasions, but not necessarily as a replacement for the manufacturers sales tax.

Next came the Royal Commission report.[2] The first half of Vol. V was devoted to the sales tax question, an issue on which the Commission had received a number of submissions. While this section is brief compared to the lengthy volumes on the income tax, it presents a well reasoned analysis of the issues and the relative merits of the different forms. The defects in the present tax were noted, and a much more drastic reform was proposed than that of the Carter Committee: "We recommend......that the federal government should replace the manufacturer's sales tax with a tax at the retail level;..."[3] The report also recommended that the Federal Government negotiate with the provinces to induce them to establish the same tax base and to collect the Federal sales tax along with their own sales taxes.[4]

The report was reviewed at the April 1967 Conference of the Canadian Tax Foundation, and a variety of objections were raised, particularly by retailers.[5] Because the government concentrated first on income tax reform,

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[1]"Industry Discounts and Appeals Procedures," Proceedings, op. cit., 1958, pp. 105-139; "Federal Sales Tax," Proceedings, op. cit., 1960, pp. 182-197; "ABCs of the Federal Sales Tax," Proceedings, op. cit., 1962, pp. 49-69; "Sales Taxes in Europe and Canada," Proceedings, op. cit., 1962, pp. 243-273.

[2]Report of the Royal Commission on Taxation (Ottawa: Queens Printer, 1966), See also R.M. Bird, Sales Tax and the Carter Report (Toronto: CCH Canadian Limited, 1967).

[3]Report of the Royal Commission, op. cit., p. 5.

[4]Ibid.

[5]Proceedings, op. cit., April 1967, pp. 294-314.

the sales tax recommendations were thenceforth largely ignored--except on the part of the provincial governments. Seeing themselves blamed for a sudden jump of sales taxes from 5%-8% to 13%-16%, they reacted adversely to the proposal, even though it would have increased their relative importance in the tax administration field. They also disliked possible loss of autonomy in the establishment of the tax base.

Not until June, 1975 did the Government, in the Green Paper, bring forth its provisional policy--namely, to move the tax from the manufacturing level to the wholesale level--the same proposal as the Carter Committee of 18 years before. The paper summarizes the defects of the present tax--much as they were when first presented twenty-five years ago, the tax not having improved with age (although the administration has) and not having been basically changed (except in exemptions). If anything, because of increased complexity in distribution channels, the problems have become worse rather than less serious.[1] The paper rejects the retail sales tax; although recognizing its theoretical superiority, the paper concludes that "the marginal improvement in neutrality offered by a retail sales tax over a wholesale sales tax does not at this time warrant the additional taxpayers and problems (implicit in the concurrent occupancy of a single tax field by more than one level of government) involved."--p.27. It would appear that the Federal Government has rejected the retail tax because of the adverse provincial reactions and the problems that would be involved in attempting to get coordinated operation. The wholesale tax is selected over the manufacturers tax in the belief that, being nearer to the retail level, it would be more nearly neutral and minimize the need for notional prices; in most instances, tax could be applied to the

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[1]Statement based upon observations of staff members of National Revenue.

actual price. The issues involved were discussed intensively in the midfifties, and have been discussed in other countries, and only a brief summary is necessary:

The Inherent Superiority of the Retail Tax

A sales tax is presumably designed to distribute the burdens arising from governmental activities in relation to consumer spending--under the assumption of complete forward shifting of the tax--rather than income. For this to occur in a fashion consistent with other objectives of government, certain requirements must be met:

1. Neutrality--avoidance of economic distortion:
   a. Of consumer choices among various types of goods and services, and between imported and domestic goods.
   b. Of choices by business firms among various methods of organization of production and distribution.

Failure to attain neutrality will cause loss of economic efficiency.

2. Equity--
   a. Avoidance of discrimination among various business firms.
   b. Attainment of the desired distribution of tax burden, on a horizontal basis (equal treatment of equals) and a vertical basis (avoidance of regressivity), and attainment of the desired degree of progression.
3. Administration and compliance--minimization of compliance nuisance and costs, uncertainty, and administrative costs consistent with effective collection.

The neutrality objectives can be attained fully only if the tax applies to the final retail selling price, under either a retail sales tax or a value added tax extending through the retail stage. Only with this form of

tax is the tax burden (assuming exact shifting) uniform on consumer expenditures on all taxed goods, and is the tax completely neutral among various systems of distribution. By the same token, only a retail tax is nondiscriminatory among the owners of various types of business firms and among consumers of various products. While a retail tax involves more taxpaying firms than the other forms, it is basically a simpler tax to operate because it can be applied in virtually all cases to the final selling price without adjustments. For the compliance and administrative requirements to be met fully, it is imperative that there be operation of the tax by only one level of government.

There are other requirements, of course, apart from the level at which the tax is imposed, for an optimal sales tax. These will be noted in subsequent sections.

These advantages of the retail tax were fully recognized by the Royal Commission report and at least in part by the Green paper. Yet, as noted, the proposal was rejected by the Government.

The Inherent Limitations of the Manufacturers and Wholesale Sales Taxes

By contrast, any tax imposed prior to the retail level encounters several basic defects, which are by now well known:

1. Distribution channels are extremely diverse--in Canada, more than many countries. As a consequence, when a tax is levied at any pre-retail stage, it will apply to prices that include costs of more production and distribution activity for some firms in an industry than for others, and more for some products than others. In general, any taxpaying firm that undertakes relatively more distribution functions than competing firms is discriminated against. Products of industries in which a disproportionate amount of the other overall production and distribution activity is undertaken prior to the impact of the

tax, are subject to relatively more tax per dollar of final consumer expenditure than other products. The result is to distort consumption patterns and resource allocation and discriminate against consumers with relatively strong preferences for the highly taxed goods.

2. The inevitable consequence of the effects noted in 1. is to encourage firms to push activities (storage, advertising, packaging, warranty, transport) forward ahead of the point of impact of the tax--something they cannot do with a retail tax (except to a minor extent, by encouraging consumers to perform do-it-yourself activities to get the product into final shape for use). The result is distortion of organization of production and distribution and loss of efficiency.

3. In attempting to counteract the worst sources of discrimination and distortions of the types noted, governments (including Canada) seek to make adjustments to equalize tax among different distribution systems. But this not only results in major complications and uncertainty (with such horrors as the old C circulars no one could understand and that leprechaun-like amorphous monster, the unlicensed wholesale branch), but fails to ensure complete neutrality and equality--no feasible adjustments could eliminate all inequity. The implementation appears to have improved in the last decade--but the problems remain.

4. Because distributors' margins differ widely on various goods--from 15% to 50% at least--the tax as a percentage of consumer expenditures varies widely among different goods, in a fashion entirely haphazard from the standpoint of policy--under the assumption of exact shifting. In fact, since necessities tend to have lower margins than luxuries, the effect is a perverse one in terms of usual distributional goals.

5. Complete uniformity of treatment of imported and domestic goods is impossible, with the danger that the tax on domestic goods will be greater than that on imported goods--simply because more distribution functions are

performed, in many instances, prior to the point of impact of the tax with domestic goods.

6. There is less assurance of shifting the exact amount of the tax to the consumer. With the retail tax, the levy is on the final selling price; with the pre-retail taxes, the tax is applied earlier, and there are possibilities that the subsequent price increase may not equal the amount of tax. Percentage markup techniques may result in increases to consumers in excess of the amount of the tax (pyramiding), and competitive relations and pricing methods are such in retailing that this excess may continue for long periods.

7. Pre-retail taxes encounter complications in the treatment of freight. Inclusion only of in-freight within the base of the tax encourages manufacturers and wholesale distributors to locate close to their sources of supply. Inclusion of out-freight with a manufacturers tax encourages wholesalers to locate close to manufacturers and with both forms encounters administrative problems when purchasers pick up goods with their own trucks, or sellers distribute goods in their own trucks.

8. Pre-retail taxes cannot be integrated with the provincial retail sales taxes, resulting in unnecessary duplication in compliance, collection, and audit.

9. Changes in tax rates encounter problems with regard to inventories of tax-paid goods. Adjustment of tax on tax-paid inventories is complicated; failure to adjust is discriminatory and distorts purchasing patterns when tax changes are anticipated.

10. If, as a matter of policy, it is considered desirable to include services within the scope of the tax, these cannot be included within the base of pre-retail levies, since the rendering of services is essentially a retail type of activity, for which pre-retail taxes are not geared.

The Wholesale Sales Tax vs. the Manufacturers Tax

While both manufacturers and wholesale taxes suffer from these common defects, the manufacturers tax is somewhat worse, as stressed in the Green Paper, simply because it is levied at a point farther removed from the final sales to the consumer, on all transactions passing through wholesale distributors of any type. Thus with the type of distribution system in which some manufacturers sell to wholesalers while others sell directly to retailers, the retail purchase price being the same in the two instances, the wholesale tax eliminates the discrimination and the need for adjustments, unlicensed wholesale branches, and consequent complications that arise with the manufacturers tax. The Green Paper estimates that 85 to 90 percent of all transactions could be taxed on the actual selling price. Similarly, since most importing is done at the wholesale level with subsequent sale to retailers, equality of treatment of domestic and imported goods is easier to attain. There is somewhat less opportunity for pyramiding, and to the extent that wholesale margins differ among commodities, the inequality of ratio of tax to consumer expenditures is reduced. The problem with the present tax, that no downward adjustment of taxable price is allowed in industries in which there are no sales to retailers, thus discriminating against consumers of these products, would be eliminated.

But these advantages are, in my estimation, not nearly as great as the Green Paper concludes:

1. Nonneutrality among distribution channels--Distribution channels are much more complex, certainly in Canada, than the example given above suggests--a fact that was brought out in detail in the discussion of the 1956 Carter Committee report. The basic problem is backward integration of retailers--of the assumption of wholesale and even manufacturing functions by large retail

firms. Accordingly, these firms, as is well known, buy much more cheaply from manufacurers than do their smaller competitors. The private brand situation is the extreme case of this backward integration, but it occurs frequently in less spectacular fashion. To seek to make adjustments in such cases by some form of uplift, as long used under the British purchase tax, is not only very complex but encounters strong resistance. Downward adjustments in price for tax purposes encounter far less resistance than upward adjustments even though the net result may be the same. The inherent source of the difficulty is that it is impossible to distinguish between price concessions obtained by large retailers that reflect true economies arising out of large quantity purchasing from those arising because the retailers have undertaken wholesale distribution and manufacturing functions, or arising because their bargaining power is so strong in dealing with small processors. Thus the incentive to move functions around remains; there is still incentive for firms to transfer various functions forward of the impact of the tax. This may be less common than transferring functions forward from the manufacturer, but the cases may result in severe discrimination and complaint.

2. Imports - While the import problem is less troublesome, there remains the question of equality of treatment of imports by retailers, particularly the larger ones.

3. Nonuniformity of tax to consumer expenditures and uneven shifting and pyramiding--The wholesale tax may be somewhat less objectionable, but the difference is not great--simply because retail margins are much greater than wholesale margins. Most of the source of nonuniformity and the potential pyramiding occurs at the retail level. Since a majority of all transactions already go directly from manufacturers to retailers (only 30% of manufacturers' sales are made to wholesalers, according to the Green Paper), the gain from use of the wholesale tax cannot be great.

4. Transport cost--The wholesale tax does not solve the freight element problem. The present tax, which excludes out-freight but taxes in-freight, encourages manufacturers to locate closer to the sources of supply than they otherwise would. Any attempt to tax out-freight would cause wholesalers to locate near their sources of supply. With a wholesale tax, it would be more feasible to include out-freight from wholesaler to to retailer in the tax, as retailers are less mobile, but this is difficult to do in the common situations in which goods are picked up by retailers in their own trucks and/or delivered by the manufacturer's truck , and there is no transport charge, per se. The taxing of out-freight to the retailer would certainly be opposed by areas of Canada most distant from the sources of supply.

Thus, in summary, the gains from shifting forward to the wholesale level appear to be rather limited. In addition, problems would be more serious with regard to dual wholesale-retail businesses. The 50% rule suggested in the Green Paper is workable but by no means entirely equitable.

Thus the changes proposed in the Green Paper may represent a net improvement, but are certain to generate political opposition and not solve the basic problems of any pre-retail sales tax. Charge from manufacturing to wholesale levels is a marginal change; shift to the retail level is not marginal,as the Green Paper claims. How feasible is it to move to the retail level (or a value added tax extending through the retail level) and thus solve the problems once and for all?

Feasibility of Use of the Retail Level

The common objection against the retail level of the large number of retail firms (an estimated 250,000 in Canada) is not a significant argument, since 95% or so of the retailers are already subject to a provincial sales tax. Effective integration of Federal and provincial taxes, with single

audit and collection, would simplify overall sales tax administration in Canada. The Federal Government cannot be considered in a vacuum in this regard.

The basic problem is not the number of taxpayers, but the Federal-provincial relationships involved and the provincial fears of being blamed for the high rates. The ideal system would involve joint collection and audit of the two taxes (as is done with state and local sales taxes in a number of states in the United States). Administration could be Federal or provincial. Federal operation would encounter strong provincial opposition, I am sure, and would represent one more step toward weakening the autonomy of the provinces in financial matters (although they could still use different tax rates). Provincial operation of the two taxes, as recommended by the Royal Commission, would not only utilize the well developed provincial administrative systems, but would also strengthen the relative role of the provinces. But there are two problems. The first would be the necessity of uniformity of base (or slight deviation at best); at present, there are some deviations among the provinces and between Federal and provincial, and the attainment of an agreement on uniformity would be difficult to say the least. But the major obstacle is a political one--the probable intense fear of the provinces that they would be blamed for 13% to 16% retail sales taxes. Coupled with this would be the fear of consumers that prices net of tax would not fall by the amount of the tax removed at the manufacturing level--a fear that suggests that the best time to make the change is while price controls are in effect.

Separate administration of provincial and Federal retail sales taxes without uniformity of base would be both a nuisance to the retailer and a source of unnecessary administrative expense. Yet it is not intolerable; the coverage of the two sets of taxes would inevitably be much the same, and vendors would use a joint schedule of total provincial and Federal tax to collect on each transaction. A similar system is used in several states in the United States,

where the state and the local governments apply and administer their own sales taxes, vendors filing two separate returns. This is not recommended, obviously, but it is not unworkable. But the political fears at both Federal and provincial levels of public reaction to sales tax rates as high as 16% would remain.

How strong would consumer resistance to a 16% retail sales tax be? This is impossible to assess. Norway used a 20% sales tax for some years, but kept it hidden. The United States used several 20% nonconcealed retail excise taxes during the World War II period, and these did not seem to produce intolerable reactions. The 8% rates in Quebec and other provinces are the highest general rates that have been used in Canada. If a strong publicity campaign were undertaken to convince the public that they were not actually paying more taxes--that the higher retail tax was offset by an equivalent decline in cost of the goods net of tax--it might be possible to make the transition without serious complaint. In a sense, a period of price controls is the ideal time to make the change. But politicians may feel otherwise.

A Hidden Sales Tax?

One possible solution to this problem would be to make both the taxes "hidden taxes"--merge the Federal and provincial levies and eliminate the requirement for separate quotation and collection of tax. There has long existed the belief in Canada--on the part of people who should know better--that if the provisions of the provincial laws relating to separate collection were eliminated, retailers would adjust prices to conceal the tax.[1] This

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[1] J.F. Due, "The Indirect Sales Tax Illusion," Canadian Tax Foundation <u>Tax Memo</u> No. 23, Sept., 1960.

is almost certain not to happen; retailers typically much prefer to keep the tax separate--to avoid the onus of higher prices, to simplify their accounting, to avoid interference with traditional price lines, to avoid the need to change prices when the tax rate changes, and because of their belief--probably valid--that full shifting of the tax is easier with the separate quotation rule. Actual hiding of the tax could be attained only with a mandatory requirement for concealing the tax, as some countries have done. Not only would the retail groups almost certainly fight this, but other groups would as well; the pricipal criticism made against the Green Paper in the Globe and Mail this summer was over the failure of the proposed changes to end the hidden nature of the Federal sales tax.[1] There are very good reasons for not requiring that the tax be hidden, quite apart from typical retailer opposition. There is much greater likelihood of exact shifting with separate quotation. More fundamentally, there is great merit in a democracy of keeping the taxpayers aware of the taxes they are paying--to permit more rational action on overall levels of governmental expenditures and revenues. The old German attitude that unmerklichkeit--concealment--of a tax is a strong advantage because the public does not know that they are paying, is not acceptable in a democratic society. In addition, currently, concealment of the tax is particularly objectionable in view of the objective of checking price increases.

Reform of the Existing Sales Tax

Given the obstacles to the desired changes, can significant improvements be made in the present manufacturers sales tax? Some improvements in taxpaying information and audit have been made over the years; my general impression is that the tax operates with a high degree of administrative effectiveness and a very thorough audit program. Nearly half of all accounts

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[1] Toronto Globe and Mail, July 14, July 17, and August 13, 1975.

are audited annually, and virtually all accounts within a four year time period. Few other governments do equally well. But there are still criticisms about various aspects, particularly the lack of a statutory basis for the adjustment of prices to attain uniformity among firms and the lack of the right of taxpayer appeal. It is not the purpose of this paper to examine these issues in detail. While undoubtedly some further improvements can be made, the problems discussed above are inherent in the tax; no levy imposed prior to the retail level can avoid discrimination and incentives to shift functions, operational complications arising out of adjustments, and non-uniformity of final burden.

Scope of the Federal Sales Tax

Another issue is that of the optimal scope of the Federal sales tax. Time permits only a brief summary:

1. Producers goods--As noted, a sales tax, to attain the usually accepted objectives of government, should apply only to sales for final consumption use. Taxation of sales for business use results in multiple taxation of final sales, makes investment artificially expensive, distorts the selection of production methods, and encourages firms to produce goods for their own use. Perhaps most seriously, taxation of producers goods places Canadian manufacturers at a disadvantage in competing with those of other countries. Most industrial countries and many others have turned to value added taxes of such nature that all accumulated tax--not only on materials and parts, but on all goods used in production--is rebated at export. Many industrial states of the United States free most business purchases from tax. The Canadian firms are therefore at some disadvantage, one net effect being to reduce the value of the Canadian dollar below what it would otherwise be. The Canadian Federal Government has never fully accepted the principle of taxing only sales for personal consumption so far as is possible, although it exempts most major

business purchases. The provinces have even less fully accepted the principle. Ontario has shifted position several times, the government never fully realizing the danger to its industries of taxing industrial machinery and other major producers goods. The one great merit of use of the value added tax over other forms of sales tax is that it appears to encourage governments to exclude all producers goods[1]--although its technical advantages in doing so over other forms of sales tax are probably not substantial.[2] The provinces particularly must recognize the need for adjusting their retail sales taxes to reduce the tax on inputs of manufacturers.

2. Commodity exemptions--For the requirements of neutrality, horizontal equity, and administrative simplicity to be met fully, a sales tax must apply to all consumption expenditures, on commodities and services, without exemptions. But this requirement is usually considered to conflict with the requirement for vertical equity, that the tax not be regressive and not place a significant absolute burden on the lowest income groups. The ideal solution for the problem would be complete sales tax coverage and a universal negative income tax system that would insure a minimum income for all families. But in the absence of such a system, a compromise is necessary between vertical equity and the other requirements. A second best approach is to provide a credit against income tax, with cash refunds to persons owing no income tax, representing sales tax paid on necessary minimum expenditures, as used in some states; but this approach seems to have less political appeal than exemptions. It is imperative that exemptions be limited to clearly definable

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[1]R.D. Brown, "A Federal Value Added Tax--A Canadian Viewpoint," Proceedings of the National Tax Association for 1973, pp. 84-95.

[2]Note the discussion of this issue in R.A. Musgrave, ed., Broad Based Taxes (Baltimore: Johns Hopkins Press, 1973), pp. 155-226.

categories of major importance in the budgets of the low income groups. Food exemption, inevitable in part under manufacturers sales tax because much food does not pass through a manufacturing process, may be warranted on this basis, though it unnecessarily frees numerous expenditures of middle and upper income groups, favors persons with luxurious food tastes, and creates compliance and administrative complications. Prescription drugs and some other medicines constitute the second category. But unfortunately governments in Canada, unlike most of their counterparts in other countries, have not stopped at this point. Clothing is exempted from some of the sales taxes--but studies show that clothing purchases are progressive by income group.[1] The trend in the provinces has been to add more and more exemptions of minor items (such as soap), nibbling away at revenue, creating operational problems, and accomplishing nothing but trouble.

3. Services--Purchases of services constitute consumption expenditures just as do purchase of goods. But North American sales taxes have typically concentrated on commodities; a manufacturers sales tax almost of necessity does. But if the Federal tax were to be moved to the retail level, should services be included? Theoretically, yes. But the problem is that many major serivce categories are of such nature that society is reluctant to tax them--medical, dental, hospital, legal, educational. Another group of services is rendered primarily to business firms and should not be taxed just as other business purchases should not be taxed (except by a value added tax under which the firms can credit tax paid on these services against tax liability on their sales). Other services cannot be reached for administrative reasons--personal service in the home, or foreign travel, for example; taxation of housing services creates serious problems of discrimination against tenants compared to homeowners. This leaves only a group of services rendered by commercial establishments--laundry, dry cleaning, barber shop, beauty parlor,

[1] J.M. Schaefer, "Clothing Exemption and Sales Tax Regressivity," American Economic Review, Vol. 59 (Sept. 1969), pp. 596-599.

and the like. There is some justification for taxing this group. But unfortunately the revenue yield is not great, and taxation of them does not appear to make the tax more progressive.[1] The basic situation with services is that while taxation of all services would greatly increase the base of the tax and improve the distributional pattern, making the tax less regressive, most of the major services either cannot be reached or are not regarded as suitable—so what is left will not add more than 10% to revenue and will not improve patterns of distribution. But there is no reason not to include them--and this can be done only at the retail level (or by a special tax).

Sales Tax Experience Elsewhere

In the last two decades the patterns of sales taxes throughout the world have undergone major changes. In the industrialized countries, by far the most important type of sales tax today is the value added tax. This tax, first introduced in France in 1954-55, is now the form used in all E.E.C. countries, Sweden and Norway, Austria, in Brazil at the state level, in Uruguay, Ecuador, Argentina, Chile, Bolivia, and in somewhat simplified form in several of the ex-French West African countries. Except in Africa, these taxes extend through the retail level, with exemption of small retailers in most countries.

The shift to the value added tax away from the other forms reflects several objectives:

1. In the original European Common Market countries, the desire to escape the evils of the turnover tax with a levy that is compatible with the Common Market and does not concentrate the impact of the tax on any one stage in production and distribution. As other countries joined the Common Market,

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[1] David Davies, "The Significance of the Taxation of Services for the Pattern of Distribution of Tax Burden by Income Class," Proceedings of the National Tax Association for 1969, pp. 138-146; O.E. Nelson, "Progressivity of of the Ontario Retail Sales Tax," Canadian Tax Journal, Vol 18 (Sept.-Oct. 1971), pp. 411-415.

they were committed to the change under the requirements of the Common Market.

2. On the part of other European countries, to free export transactions from all tax, under the belief that this objective is most easily realized with this form of a tax.

3. In Latin America, to escape the turnover tax without concentrating impact at one stage and yet collect much of the tax at retail levels; in the case of the countries formerly using the manufacturers sales tax, to bring wholesale and retail margins within the scope of the tax without concentrating the tax at the retail level.

4. The belief that a value added tax is more easily enforced because of the cross audit feature--tax reported as paid to the supplier by one firm should appear as an element in the suppliers' tax payments to the government.

Other major changes have included the establishment of several new manufacturers sales taxes in Africa, in both British Commonwealth and Francophone countries, but almost no additional use of them elsewhere (Guyana is an exception). The tax continues in use in Columbia and the Philippines. Retail sales taxes have been introduced in several smaller Latin American countries and Barbados, and are used in Iceland and in some states in India. No new wholesale sales taxes were introduced. Sweden, Great Britain, and Ireland shifted from this form as they joined the Common Market, and only Australia, New Zealand, Switzerland, and Portugal now use this tax.

The general experience is that any form of sales tax, other than the turnover or cascade tax,[1] will work reasonably well under the appropriate conditions. The manufacturers tax works satisfactorily under the simple

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[1]Now confined to Spain, Mexico, and a few small countries.

market structures of least developed countries. Retail sales taxes can be administered in countries with well developed commercial retailing, if, in less developed countires, small firms are excluded and the rate is relatively low. The value added tax functions well if properly designed.

The experience with the wholesale tax is relatively limited, and no recent studies of experience are available. Great Britain had substantial difficulty with its purchase tax, with regard to uplift on direct sales to retailers at low prices, delineation of commodities in various rate groups, and anticipatory effects of rate changes--but these were attributable in large measure to the high rates, the use of several different rates, and the frequent rate changes. Australia and New Zealand appear to have had little difficulty with the tax and do not use uplift on direct sales. Earlier enquiries concluded that failure to provide uplift did not result in serious complaints from smaller firms.[1] The question of tax treatment of freight has been the most controversial one in Australia.

Switzerland has provided a circuit-breaker type of relief for the small firm--any retailer can register as a taxpayer, buy tax free and pay tax on his sales at a lower tax rate. This protects the smaller retailer subject to competition from firms buying direct from manufacturers at low taxable prices, provided the rate differential adequately reflects the margins.[2] Sweden abandoned the wholesale tax primarily because of the

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[1] J.F. Due, "Report of the Sales Tax Committee: One Year in Retrospect," Canadian Tax Journal, Vol. 5 (March-April 1957), pp. 88-105; "The Wholesale Sales Tax in New Zealand," Canadian Tax Journal, Vol. 4 (Sept.-Oct. 1956), pp. 351-356; and Report of the Sales Tax Committee, 1956, op. cit.

[2] J.F. Due, "Sales Taxation and Diverse Distribution Channels--The Swiss Solution," Canadian Tax Journal, Vol. 9 (March-April 1961), pp. 129-133.

desire to exclude all producers goods from the tax.

On the whole, the experience of these countries, unfortunately not studied in recent years, indicates that the taxes are acceptable elements in the tax structures over long periods, but throw little light on the question of whether such a levy would be more satisfactory in Canada than the present form of sales tax. None of these countries face the problem of dual sales taxes at national and provincial levels.

Lessened Federal Use

One final option is that of phasing out of the Federal sales tax, leaving this sphere to the provinces, as suggested by the Royal Commission. In effect the Federal Government would take over still greater responsibility for income taxes and let the provinces rely more heavily on sales taxes --the provinces presumably raising their rates as the Federal Government lowered its rate. The idea is not without merit; the income tax is the most effective tax from the standpoint of fiscal policy and the one most effectively operated at the Federal level. It can be argued that the Federal Government does not need to use a sales tax--just as the United States Federal Government does not.

This approach, however, is open to several types of criticism:

1. The provincial taxes are anything but ideal models of sales taxation. For most effective operation and neutrality, they have far too many exemptions of consumption goods, and they apply to an excessive range of sales for business purposes. The provinces have never established a clearly defined rationale of their sales tax structures.

Furthermore, no satisfactory approach to interprovincial transactions has ever been worked out. Purchases from outside the province are typically not reached by the tax; on the other hand, the provinces stubbornly refuse

to grant credit for sales tax paid other provinces, thus creating the possibility of double taxation.

2. The issue of virtual sole Federal reliance on the income tax can be argued both ways. Obviously the Federal Government could dispense with the sales tax. But to do so could easily result in higher overall income tax burdens--since the provinces might not reduce their own to an equivalent degree--with possible adverse effects upon investment and economic development, because of their fear of public reaction to high sales tax rates. This change offers two primary merits by usual standards: the tax structure is likely to be more progressive; and the less depressing effect on consumption might facilitate attainment of a higher level of employment. On the other hand, the higher income taxes could have a depressing effect upon investment incentives and capital availability, more than offsetting the influence of increased consumption demand. We do not know enough above the determinants of real investment to be certain of the net effect. The income tax is a better fiscal policy intrument, its yield rising with inflation, even with the indexing feature, falling more rapidly than national income when business activity falls. The sales tax yield is less responsive; thus greater reliance on income taxes, despite indexing of the Federal income tax, should be to provide greater stabilization effect--but this is a disadvantage to those who regard Federal deficits as a serious menace. This is a very complex issue, and this discussion, all that time permits, does not do it justice. But the conclusions are by no means obvious.

Conclusion

Clearly the optimal solution for sales taxation in Canada is to move the Federal sales tax to the retail level and merge the Federal and provincial sales taxes into a single levy, excluding all producers goods, and applying

to all consumption expenditures except categories in which there is a very strong case for exemption, with administration either by the Federal or provincial governments. If the value added technique were used--and there is no clear evidence that it is superior in the Canadian context to a retail sales tax--administration would of necessity be Federal. Only the retail tax can eliminate the difficulties inherent with the manufacturers or wholesale taxes.

But if the government rules this out--as it appears to do, at least provisionally, because of the possible public reaction to a sales tax rate as high as 16% and the resistance of the provinces to adjustments in their sales taxes to conform with a national standard and their fear of blame for the high levy, any solution is second best; the problem is to select among various evils. To move the Federal tax to the retail level and conceal it would encounter serious opposition and is objectionable in principle. To have a separate visible Federal retail tax would avoid the requirement of coordination of provincial and Federal taxes but involve unnecessary duplication in compliance and administration and not escape the popular reactions to the high rate--although otherwise attaining the advantages of the retail level. To move to the wholesale level would offer only minor gains over the present tax and is, in my estimation, not worth the trouble. Yet to remain with the present tax is to perpetuate the inherent problems with this form of tax. The provinces, by de facto preemption of the optimal form of sales tax, have blocked the Federal Government for making the optimal change in its sales tax. There is no easy way out.

There is still the possibility, however, that the government might reverse the provisional position, convince the public that they would pay no more sales tax under the revised system than they are at present, persuade

the provinces to accept a uniform tax base with provincial collection (the Federal Government would have to collect in Alberta and the territories), and thus attain the optimal system. But I am not too hopeful.

Appendix I

Major Sales Tax Systems

This table is designed to provide a general view of the use of various forms of sales taxation. Often more than one rate is used; the rates given are not necessarily current, as changes are frequent.

Country	Year Introduced	Basic Rate, 1974[4]
Manufacturers Sales Tax[1]		
Canada, Federal	1923	12
Columbia	1965	4
Ghana	1965	11.5
Kenya	1973	10
Uganda	1968	10
Tanzania	1969	12
Malaysia	na	5
Pakistan	1951	20
Brazil (federal)	na	8
South Africa	1969	10
Greece	na	7
Turkey	na	various
Indonesia[6]	1950	10
Guyana	1969	various
Philippines	1936	7
Wholesale Sales Tax[2]		
Australia	1930	15
New Zealand	1933	20
Switzerland	1941	4
Portugal	1966	7
Retail Sales Tax		
Canada, provinces	1935-	5-8
United States, states and localities	1932-	3-6
Iceland	1960	7.5
Paraguay	1969	3
Nicaragua	1972	5
Honduras	1964	4
Costa Rica	1967	5
Barbados	1975	10
Finland[5]	na	12.4
Turnover Taxes[3]		
Spain	1964	2
Mexico	na	4

1. Plus several ex-French countries of west and equatorial Africa.
2. Israel applies a wholesale tax to a number of commodities.
3. Plus Taiwan, Ethiopia, Sri Lanka, South Korea, some Indian states.
4. Many of these taxes use more than one rate.
5. Retail and wholesale dual tax.
6. Some multiple application.

Value Added Taxes

Country	Year Introduced	Rates, 1974[1]	Features
EEC Countries			
France	1955	20; 7, 17.6, 33.3	Through retail level since 1968
Germany	1968	11; 5.5	Through retail
Netherlands[3]	1969	16; 4	"
Luxembourg[3]	1970	10; 2.5	"
Belgium[3]	1971	18; 6, 14, 25	"
Italy	1973	16; 6, 30[4]	"
Ireland	1972	6.75; 11.11; 19.50; 36.75	"
United Kingdom	1973	8	"
Denmark	1967	15	"
Other European Countries			
Sweden	1969	17.65; 3.09, 9.89	"
Norway	1970	20	"
Austria	1973	16; 8	"
Latin America			
Chile	1975	20	"
Brazil[2] -- state	1967	16.3 to 19	"
Uruguay	1968	14; 5	"
Ecuador	1970	4; 9	"
Argentina	1975	13; 21	"
Bolivia	1973	5	"
Partial:			
Peru[5]	1972	15; 3, 7, 10, 25	Through wholesale only
Africa (levies known as value added taxes, but primarily limited to the manufacturing sector)			
Senegal	1966	10; 4.25; 33	Primarily on manufacturers
Malagasy Republic	1969	13.6; 6.4	Through wholesale
Ivory Coast	1960	10; 20; 23.9	Optional beyond manufacturing
Algeria	na	25; 42.9	Primarily on manufacturers
Morocco	1961	14.6; 18.6; 25	"
Tunisia	1955	17.8	"

Rates shown are effective rates, adjusted to a tax exclusive basis if imposed tax-included.

1. Basic rate given first.
2. The Federal tax has value added features but is confined to the manufacturing sector.
3. The Benelux countries agreed in 1973 on a uniform basic rate of 16 percent, with a 4 percent reduced rate on necessities.
4. Plus other rates.
5. The credit for tax paid on purchases is severely limited in the manufacturing sector.

Sources: S. Cnossen, "Sales and Excise Systems of the World", Finanzarchiv, Vol. 33, #2, 1975, pp. 177-236, and other sources.

Appendix II

Provincial Retail Sales Tax Rates
as of May 1975

Basis: Retail Selling Price	Nfld.	P.E.I.	N.S.	N.B.	Que.	Ont.[a]	Man.	Sask.	Alta.	B.C.
Goods (tangible personal property)	8%	8%	7%	8%	8%	5%	5%	5%	nil	5%
Minimum taxable sale	8¢	26¢	16¢	12¢	26¢	21¢	26¢	15¢	—	15¢
Prepared meals	8%	8%	7%	8%	8%[b]	10%	5%	nil	nil	nil
Minimum taxable meal	nil	$2.00	$3.00	$2.00	$2.00	$4.00	$3.00	—	—	—
Alcoholic beverages	8%	10%	7%	8%	8%[b,c]	10%	10%[c]	5%	nil	5%
Taxable Services										
Hotel and motel accommodation ..	8%	8%	7%	8%	8%[b]	5%	5%	5%	nil	5%[b]
Telecommunications other than telephone	8%	nil	nil	8%	8%[f]	5%	5%	5%	nil	nil
Telephone services										
Local	8%	8%	7%	8%	8%	5%	5%	5%	nil	5%
Long distance	8%	nil	[d]	8%[e]	8%[f]	5%[e]	5%[e]	5%[e]	nil	nil
Natural gas	8%[g]	nil	nil	nil	8%[g]	nil	5%[h]	nil	nil	5%
Electricity										
Residential uses	8%	nil	50¢ P.M.[i]	nil	8%	nil	5%[h]	5%[j]	nil	5%
Other	8%[g]	nil	$1–$30 P.M.[i]	nil	8%[g]	nil	5%[h]	5%[j]	nil	5%
Laundry and Dry Cleaning	8%	8%	nil	nil	nil	nil	5%	nil	nil	nil

[a] Ontario's retail sales tax rate is 5% for the period April 8, 1975 to December 31, 1975, after which it reverts to 7%. [b] Levied under separate statutes: in Quebec—Meals and Hotels Tax Act; in British Columbia—Hotel and Motel Tax Act. [c] The 10% rate in Manitoba applies to liquor, wine and imported beer; domestic beer is taxed at 5%. In Quebec beer and weak cider served in taverns or beer parlours are exempt. [d] In Nova Scotia calls over 25¢ are taxed at 5¢ for each 50¢ under the Corporations Tax Act. [e] New Brunswick, Ontario, Manitoba and Saskatchewan have special tax schedules rounded to multiples of 5¢ for long distance calls originating from pay telephones. [f] Levied as a telecommunications tax in Quebec. [g] In Newfoundland manufacturers are exempt from tax on energy used in their plants. In Quebec energy used in manufacturing and processing is exempt up to 90% of the value of the energy purchased. [h] Levied as a utilities tax in Manitoba, which also applies to manufactured gas delivered by a gas pipe distribution system, coal and its derivatives (except briquettes), and steam or hot water purchased to heat buildings except private domestic dwelling units. [i] Monthly rates on electricity levied under Health Services Tax Act in Nova Scotia. [j] In Saskatchewan an exemption for electricity used for heating is provided.

Sources: Provincial statutes and regulations.

Reproduced from Canadian Tax Foundation, Provincial and Municipal Finances, 1975, p. 65.